Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:[redacted]:TL-N-4513-00
[redacted]

date:

to: Manager, Group [redacted]
Attn: [redacted]

from: Associate Area Counsel, LMSB, [redacted]

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subject: **Request for Advisory Opinion**
Deductibility of Postpetition Interest
Taxpayer: [redacted]

We are writing in response to your request for our opinion regarding the deductibility of interest that accrued after the taxpayer was placed into a Chapter 11 bankruptcy.

ISSUES

1. Whether an accrual basis taxpayer is entitled to deduct interest that accrues after the taxpayer is placed in a Chapter 11 bankruptcy.

2. Whether the result is different for original issue discount.

CONCLUSIONS

1. There are circumstances under which a taxpayer can deduct post-petition interest; however, under the facts of this case, the taxpayer is not entitled to claim a deduction for postpetition interest.

2. The same result applies to interest in the form of original issue discount.

FACTS

An involuntary petition under Chapter 11 of the Bankruptcy Code was filed against [redacted] or "the taxpayer") (now known as [redacted]) on [redacted]. The taxpayer ultimately consented to the bankruptcy and an order for relief was entered on [redacted]. A Plan or Reorganization was confirmed in [redacted].

[redacted] is a holding company that owns only stock of other corporations, all of which were wholly owned subsidiaries, except for [redacted]. The taxpayer filed consolidated returns for all relevant periods as parent of the controlled group. All of the taxpayer's subsidiaries, except [redacted] were also in bankruptcy and the cases were jointly administered.

[redacted]

The taxpayer claimed interest expense deductions for the post-petition interest that would have accrued on these liabilities on its [redacted] and [redacted] income tax returns, as follows:

	[redacted]	[redacted]
Class [redacted] Debt:		
Bank Credit Agreements	$ [redacted]	$ [redacted]
Serial Zero Coupon Senior Notes	[redacted]	[redacted]
Total Class [redacted] Debt	$ [redacted]	$ [redacted]
Class [redacted] Debt:	[redacted]	[redacted]
Class [redacted] Debt:	[redacted]	[redacted]
Total	$ [redacted]	$ [redacted]

The creditors holding the Class [redacted], Class [redacted], and Class [redacted] Debts did not file claims for postpetition interest in the taxpayer's bankruptcy proceeding. The confirmed Plan of Reorganization did not provide for payment of any postpetition interest to the creditors holding Class [redacted], Class [redacted], and Class [redacted] Debts. The taxpayer has never paid this post-petition interest to holders of the Class [redacted], Class [redacted], and Class [redacted] Debts.

In the taxpayer's bankruptcy proceeding, two creditors who held only Class [redacted] Debts through [redacted] ($[redacted] and [redacted] (n.k.a. [redacted]) ($[redacted], served on the unsecured creditors' committee.

On its 10-K for the period ending [redacted], the taxpayer reported that it made distributions through its

bankruptcy plan of reorganization, on the Class [redacted], Class [redacted], and Class [redacted] Debts as follows:

	Obligation Exchanged			
Class [redacted]:	Face Amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash	$[redacted]		
	Senior Secured Notes	[redacted]		
	Senior Subordinated Notes	[redacted]		
	Class [redacted] Common Stock ([redacted] shares @ $[redacted]	[redacted]	$[redacted]	
	Excess surrendered			$[redacted]
Class [redacted]:	Face Amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash		$[redacted]	
	Excess surrendered			$[redacted]
Class [redacted]:	Face amount	$[redacted]		
	Prepetition interest	[redacted]		
	Amount Exchanged		$[redacted]	
	Consideration:			
	Cash	$[redacted]		
	Class [redacted] Common Stock ([redacted] shares @ $[redacted]	[redacted]	$[redacted]	
	Excess surrendered			$[redacted]
Excess of Obligations Exchanged over Consideration Received				$[redacted]

In the analysis comparing distributions in the taxpayer's Chapter 11 case with hypothetical distributions in a Chapter 7 case, the taxpayer reports the following:

Class	Claim	Chapter 7 Recovery	Chapter 11 Recovery
Class [redacted]	$[redacted]	$[redacted]	$[redacted]
Class			
Class			

ANALYSIS

Under I.R.C. § 163(a), a taxpayer may generally deduct all interest paid or accrued on indebtedness during a taxable year. For debt instruments issued after July 1, 1982, I.R.C. § 163(e) provides that the issuer may deduct the portion of any original issue discount that is amortizable during the year. To be deductible, there must be a fixed and legally enforceable obligation to pay the interest. Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214, 216-17 (2d Cir. 1952), cert. denied, 344 U.S. 874 (1952); United States v. Diehl, 460 F. Supp. 1282, 1303 (S.D. Tex. 1978), aff'd, 586 F.2d 1080 (5th Cir. 1978); D. Loveman & Son Export Corp. v. Commissioner, 37 T.C. 776, 805-06 (1960), aff'd, 296 F.2d 732 (6th Cir. 1961), cert. denied, 369 U.S. 860 (1962); Bakhaus and Burke, Inc. v. Commissioner, T.C. Memo. 1955-227.

In a bankruptcy proceeding, the general rule is that claims for postpetition interest on prepetition debts of the debtor are not allowed as claims against the estate. 11 U.S.C. § 502(b)(2); Ford Motor Credit Co. v. Dobbins, 35 F.3d 860, 869 (4th Cir. 1994). As the Congressional committee reports to the Bankruptcy Code state "interest stops accruing at the date of the filing of the petition." H.R. Rep. No. 595, 95th Cong., 1st Sess. 353 (1977); reprinted at 1978 U.S.C.A.A.N. 5963, 6309; S. Rep. No. 989, 95th Cong., 2d Sess. 63 (1978), reprinted at 1978 U.S.C.A.A.N. 5787, 5849.

There are exceptions under which postpetition interest is allowable as a claim against the estate. Postpetition interest does accrue in the following circumstances:

1. Postpetition interest accrues on postpetition administrative expenses (11 U.S.C. § 503);

2. Postpetition interest accrues on prepetition debts that are not dischargeable (11 U.S.C. §§ 523 and 1141(d));

3. In a Chapter 11 case, if a senior class dissents, it is entitled to full payment (including interest) before junior classes can receive distributions (11 U.S.C. § 1129(b)(2)); and

4. Postpetition interest accrues on prepetition secured claims if the value of the collateral securing that claim is greater than the amount of the claim (11 U.S.C. § 506(b)).

Unless one of these exceptions applies, no deduction is allowable for the postpetition interest claimed in this case because, under the general rule in 11 U.S.C. § 502(b)(2), there was no legally enforceable obligation to pay the interest.

In this case, the Class [redacted], [redacted], and [redacted] Claims at issue are prepetition claims, not administrative claims, so the first exception does not apply. There is nothing to indicate that the Class [redacted] and [redacted] Claims are nondischargeable, so the second exception does not appear to apply. The Class [redacted] and Class [redacted] creditors did not object to confirmation of the plan, so the third exception does not apply.

The taxpayer claims that the fourth exception applies because at least the Class [redacted] Claims were entitled to postpetition interest under 11 U.S.C. § 506(b) as oversecured claims. The schedules of assets filed by the taxpayer in its bankruptcy do not report sufficient value for the assets listed to fully secure the Class [redacted] Debts. However, some assets, primarily the interests in the subsidiaries, are listed at an undetermined value. The taxpayer argues that the value of these assets were actually such that the Class [redacted] Debts were oversecured and therefore entitled to postpetition interest. This position is not supported by the facts in this case.

Under 11 U.S.C. § 1102(a)(1), the U.S. Trustee is required to appoint a committee of unsecured creditors and may also appoint other committees of creditors or equity holders as is deemed appropriate. In the taxpayer's bankruptcy two of the creditors who served on the committee of unsecured creditors, [redacted] and [redacted] (n.k.a. [redacted], held only Class [redacted] Debts. A creditor holding only a secured claim cannot serve on the unsecured creditors' committee. See 7 Lawrence P. King, Collier on Bankruptcy, ¶ 1102.02[2][a][vii] (15th ed. revised 2000). Creditors holding undersecured claims will normally be allowed to serve on the unsecured creditors committee because of the unsecured portion of their claim. In re Walat Farms, 64 B.R. 65 (Bankr. E.D. Mich. 1989). However, some court do not even allow

an undersecured creditor to be a member of the unsecured creditors' committee because of the potential conflict of interest with wholly unsecured creditors. In re Glendale Woods Apts., Ltd., 25 B.R. 414 (Bankr. D. Md. 1982). Since these two creditors served on the unsecured creditors committee, it is clear that their claims were considered to be undersecured, at least by the creditors and the U.S. Trustee. If the Class [redacted] Claims were undersecured, then the Class [redacted] and Class [redacted] Claims would have to have been undersecured since they were subordinated to the class [redacted] claims.

In addition, if the Class [redacted] Creditors' were oversecured, they would be entitled to receive not only full payment of their secured claims, but also postpetition interest. These creditors, however, did not object to a plan that not only failed to provide for postpetition interest, but also paid them significantly less than the full principal balance of their claims. This makes the taxpayer's position that the Class [redacted] Claims were oversecured suspect.

The taxpayer has failed to provide any objective evidence to demonstrate that the Class [redacted] or [redacted] Claims were oversecured. To support its position, the taxpayer has provided documentation to show that there have been other bankruptcy proceedings in which secured creditors have received less than full payment of their claims, but distributions were nonetheless made to subordinate creditors. All this proves is that under certain circumstances creditors who could object to a Chapter 11 Plan and invoke the absolute priority rule will allow the plan to be confirmed. This in no way proves that a creditor's claim was oversecured or establishes the value of the collateral securing a creditor's claim. The data provided by the taxpayer does not establish the creditors' motives, financial or otherwise, for agreeing to confirmation of a particular plan and do not establish that the senior creditors were oversecured.

The taxpayer also argues that the value of the stock issued on the Class [redacted] and Class [redacted] Claims through the confirmed plan of reorganization was actually greater than the $[redacted] price placed on the stock. The taxpayer takes the position that this stock had an actual value of $[redacted] per share, so the total value distributed on the Cclass [redacted] and Class [redacted] Claims was enough to cover postpetition interest. The only support offered for this position is the price paid for stock of [redacted] in an initial public offering approximately [redacted] months after the company emerged from bankruptcy, discounted back at [redacted] percent to the date the plan was confirmed.

This argument is not persuasive. There are numerous reasons this proposed valuation is not accurate, including:

- this valuation method does not take into account changes in circumstances between the date the plan was confirmed and the date of the initial public offering;
- the stock of a company in bankruptcy is not comparable to the stock of a company, even the same company, outside of bankruptcy;
- a discount rate of [redacted] percent is an unreasonably low rate of return to entice an investor to take a chance on a company emerging from bankruptcy;
- the $[redacted] price reflects an actual arm's length sale between unrelated parties with adverse interest on the valuation date in question;
- the debtor-in-possession had a fiduciary duty to receive full value for the stock to maximize the return to all creditors, the taxpayer is suggesting that it sold the stock for less than [redacted] percent of its value;
- if the value of the stock had been significantly higher than the amount paid, it is unlikely that the U.S. Trustee and the Bankruptcy Court would have allowed the plan to be confirmed; and
- the taxpayer's analysis comparing recovery under the plan of reorganization with hypothetical liquidation in a Chapter 7 indicates that there was insufficient value to fully secure the Cclass [redacted] Claims or to provide any security at all to Class [redacted] and Class [redacted] Claims.

The taxpayer further argues that postpetition interest is deductible under the principles set forth in Rev. Rul. 70-367, 1970-2 C.B. 37. This ruling is distinguishable because it was based on a provision of the former Bankruptcy Act applicable only to railroad bankruptcies that has no parallel in the present Bankruptcy Code. In particular, the section of the former Bankruptcy Act for railroad reorganizations had no provision akin to section 502(b)(2) of the current Bankruptcy Code, which does not allow a claim as a matter of law for an issuer's postpetition interest.

The postpetition interest on Class [redacted] Class [redacted] and Class [redacted] Claims is not deductible because there was no legal obligation to pay this interest.

Furthermore, the postpetition interest is not deductible because of the "all events test" in I.R.C. § 461(h). See In re West Texas Marketing Corp., 54 F.3d 1194 (5th Cir. 1995), cert. denied, 516 U.S. 991 (1995). Under the all events test, a liability is deductible in the year in which: 1) all events have occurred that establish the fact of the liability, 2) the amount of the liability can be determined with reasonable accuracy, and 3) economic performance has occurred. Treas. Reg. § 1.461-1(a)(2)(i).

In this case, the last two factors of the all events test are not in dispute. The amount of the interest can be accurately determined by looking at the interest rate on the debts, the amount of time that has passed, and the unpaid balance of the debt. For interest deductions, economic performance occurs as the interest cost economically accrues. Treas. Reg. § 1.461-4(e). The only issue here is whether all of the events necessary to establish the fact of the liability have occurred.

As discussed above, interest generally does not accrue after a bankruptcy petition is filed. The fact necessary to establish the liability would normally not occur until a plan of reorganization is confirmed that provides for payment of the postpetition interest. There could be other events that establish a creditor's right to postpetition interest. For example, if it became evident that a secured creditor is oversecured, it would be appropriate to accrue postpetition interest on that creditor's debt. This could happen if the secured creditor sought and was granted adequate protection under 11 U.S.C. § 364, particularly if the adequate protection granted was in the form of postpetition interest. In this case, no event ever occurred that would establish the fact of a liability for postpetition interest. The postpetition interest was never provided for in a confirmed plan and postpetition interest was never paid by the taxpayer.

Alternatively, if the postpetition interest is found to be deductible as it accrues, the interest should all be recaptured in [redacted], when the plan of reorganization was confirmed providing that nothing would be paid on the postpetition interest. See Hillsboro National Bank v. Commissioner, 460 U.S. 370, 383 (1983).

These same principles apply equally to the accrual of postpetition interest in the form of original issue discount. In re Pengo Industries, Inc., 962 F.2d 543 (5th Cir. 1992), aff'g 129 B.R. 104 (N.D. Tex. 1991); In re Chateaugay Corp., 961 F.2d 378 (2d Cir. 1992). The result will be the same whether the

claimed deduction is for the postpetition accrual of interest or the postpetition amortization of original issue discount.

If you have any questions regarding this matter, please feel free to contact me.

[redacted]
Attorney

APPROVED:

[redacted]
Acting Associate Area Counsel